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IN THE

Supreme Court of the United States

October Term, 1963.

No. 635

WILLIAM K. CARPENTER and FRANCIS K. CARPENTER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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IN THE

SUPREME COURT OF THE UNITED STATES.

October Term, 1963.

No.

WILLIAM K. CARPENTER AND FRANCIS K. CARPENTER,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit entered in the above-entitled case on August 29, 1963.

OPINIONS BELOW.

The opinion of the Tax Court of the United States is Tax Court Memorandum Decision 1962-176. The Tax Court Memorandum Findings of Fact and Opinion is reported at 21 C. C. H. T. C. M. 975 (1962). It is printed in the Appendix for the use of the Court below at pages 167a-177a. The opinion of the United States Court of Appeals for the Third Circuit filed on August 29, 1963 and modified on October 11, 1963 (said modification being subsequently corrected on October 21, 1963), is not yet reported but is printed, along with the corrected modification, in Appendix A hereto, pages 34-41.

JURISDICTION.

The judgment of the Court of Appeals for the Third Circuit was entered on August 29, 1963 and is printed in Appendix B hereto, page 41. The jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(1).

QUESTIONS PRESENTED.

1. Where a taxpayer obtains loans to finance the purchase of a single premium annuity, is interest paid by him on the loans deductible for federal income tax purposes where the evidence shows (a) the face amount of the annuity purchased is appropriate for the taxpayer's financial and family needs, (b) the loans will be easily repayable by the taxpayer when certain trusts of which he is presently only a life tenant vest in him as remainderman, (c) the taxpayer purchases the annuity with borrowed funds rather than waiting for the future vesting of the trusts in order to avail himself of the economy of a youthful purchase of such an annuity and (d) the taxpayer has at all times retained the policy for the very reason he purchased it, namely his estate plan?

2. Should this Court grant certiorari where a court of appeals has affirmed a decision of the Tax Court for two reasons, the first of which both parties agree is erroneous and in conflict with long-established tax law and the second of which demonstrates a failure to apply the scope of appellate review required both by this Court and by Congress?

3. Where the Commissioner of Internal Revenue has issued a considerable number of official rulings which are widely circulated and common knowledge, and where a taxpayer acts with knowledge of those rulings when he might have postponed acting had there been no such clearly-stated administrative policy, may the Commissioner reverse those rulings retroactively to the detriment of the taxpayer, while at the same time continuing to give effect to the policy as to some other taxpayers?

STATUTES INVOLVED.

The statutory provisions involved are the following provisions of the Internal Revenue Code of 1954, Title 26 U. S. C.:

Section 163(a) which provides:

"There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

Section 264(a) (2) which provides:

"(a) General Rule.—No deduction shall be allowed for —

. . .

"(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract. "Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954."

Section 7482 which provides:

"The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code; in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury . . ."

STATEMENT OF THE CASE.

This action was instituted in the Tax Court of the United States by William K. Carpenter and Francis K. Carpenter, petitioners,[1] challenging a proposed deficiency on their 1954

[1] The petitioners were husband and wife and filed a joint return. The transactions in this case involved only William K. Carpenter, the husband; when the term "petitioner" is hereafter used, it refers to him.

federal income tax return. The alleged deficiency arose out of the disallowance, by the Commissioner of Internal Revenue, respondent, of a claimed interest deduction. The Tax Court (Judge J. Gregory Bruce) sustained the Commissioner and the Court of Appeals for the Third Circuit (in an opinion by Judge William F. Smith) affirmed the Tax Court.

The uncontradicted evidence in the case shows the following facts.

In December, 1953, and January, 1954, petitioner, who was then not quite 35 years of age, was contacted by William J. Robinson, an independent life insurance broker, who found that petitioner, although he had a wife and two children, had no life insurance, no annuities and no endowment policies of any kind. Robinson concluded that he could provide help for the petitioner with respect to an estate plan and an insurance program. His first inclination was to try to sell life insurance to petitioner, but he decided that was impossible because petitioner's activities included piloting his own plane, racing sports cars and participating in safaris and wild game hunts. These pursuits subjected his life to such unusual risks that Robinson knew that no life insurance company would be willing to insure petitioner's life with straight life insurance policies. The broker then concluded that petitioner should purchase an annuity and expressed this opinion to petitioner. The broker explained to petitioner the goals which an annuity could achieve for him under the particular circumstances in which petitioner was at that stage of his life. The major advantage for petitioner was that an annuity would provide substantial monthly income during his advanced years (from and after his reaching 69-2/3 years of age) which would enable him to put into effect an estate plan which could include the making of generous gifts to his children without significant interference with his standard of living. Also, an annuity would

make cash immediately available for the petitioner's heirs when he dies, as compared with the slow distribution of assets through the administration of his estate. An additional advantage of an annuity was to provide a source for borrowing funds at the low interest rate of 4%. All of these purposes were particularly significant to petitioner because of the fact that he was, and is, the remainder beneficiary of very substantial trusts (considerably more than three-quarters of a million dollars) which will terminate upon the death of his mother. Therefore, when his mother dies he will have substantial principal which he does not have now and which he did not have in 1954.

The broker, being himself convinced that his prospect's best interests would be served by the purchase of an annuity, convinced petitioner that the latter should purchase such a policy. At this juncture there arose the question of how petitioner could pay for such a policy in 1954. Petitioner's cash position, at the time of his conversations with the insurance broker, was such that it was virtually impossible for him to pay a substantial premium to purchase such an annuity policy. His choice, therefore, was either to delay purchasing such an annuity until his cash position became more liquid by the vesting in him of principal then in trust, or to purchase the annuity immediately by borrowing the money necessary to pay the premium. The broker pointed out the advantages of buying an annuity at as young an age as possible; in brief, as the purchaser grows older it takes a greater premium to buy the same future monthly annuity or, put another way, as the purchaser grows older the same premium buys a smaller future monthly annuity. Petitioner recognized the correctness of this proposition but he knew, as everyone does, that interest must be paid on borrowed money. In deciding whether it would be more economical, in the long run, to wait until his mother's death and buy the annuity with the principal of the trusts which

would then vest or whether to buy the annuity then and there on borrowed funds, it became important to know the answer to the question of whether interest paid on a loan made for the purpose of paying a premium on an annuity is deductible for tax purposes. Robinson, the broker, assured petitioner that it was, obtained from various sources seven letter rulings issued by the Commissioner of Internal Revenue so stating, as well as a letter by Senator George, Chairman of the Senate Finance Committee so stating, and showed these to petitioner. Convinced that it was the right thing to do, petitioner purchased the annuity in 1954 rather than waiting to purchase it at some later time.

The mechanics of the transaction occurred as follows: petitioner applied for the annuity from Old Republic Life Insurance Company on January 19, 1954 and paid the $500,000 premium on January 25, 1954 with an $8,000 personal check and the proceeds of a loan from the Philadelphia National Bank evidenced by his promissory note in the sum of $492,000 and an assignment of the policy. The interim financing by the Bank was replaced by a loan in an identical amount from the insurance company. The loan from Old Republic was evidenced by both an application for the loan, an annuity loan agreement and loan provisions. Petitioner paid the Bank $400 (being $54.67 interest and a clearance charge of $345.33) and prepaid one year's interest to the insurance company in the sum of $19,680. At the conclusion of the transaction, the Bank paid the insurance broker his $15,000 commission in accordance with the insurance company's instructions and notified Old Republic of the consummation of the transaction.

Policy AN102 issued by Old Republic Life Insurance Company designated petitioner as the annuitant and the insurance company agreed to pay petitioner a life annuity of $10,371.82 each month beginning on January 19, 1989 (when petitioner would be 69-2/3 years of age) and provided fur-

ther that if petitioner died before the commencement of any income settlement or before the cash value of the contract had been paid, the single premium paid, without interest, or the cash value to which petitioner would have been entitled at the date of his death, whichever should be greater, less any indebtedness and advances, would be payable to his wife.

Since petitioner had purchased the annuity in January, 1954, as a tool for future use in his estate plan, he decided in November, 1954, that he should prepay several additional years' interest in order to allow him to put aside the policy and give it no further thought at least until such time as he would be ready to make it more actively useful for that purpose; i.e., when he receives principal held in trust during the lifetime of his mother. He, therefore, prepaid seven additional years' interest in the amount of $170,154.33. Thereafter he borrowed the policy's increased loan value of $113,000.

Over seven years elapsed between the above transactions and the trial and petitioner did nothing further with respect to the annuity policy. He did not surrender it to receive repayment of the prepaid interest even after his interest deduction was challenged and disallowed by the Commissioner. He continued to own the policy and it is still in full force and effect. He has not repaid the loan against the policy because the trusts, of which he is a life tenant and a remainderman, have not terminated and there has been no significant change in his cash position.[2]

In summary, during the calendar year 1954 petitioner paid to the insurance company a total of $189,834.33 which was regarded both by him and Old Republic Life Insurance Com-

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[2] It was seven years from 1954 to 1961; i.e., from the time of the purchase of the annuity to the time of trial. All of the same conditions prevail even now; two years since the trial in the Tax Court.

pany as interest on the above-described loans. Petitioner's timely filed federal income tax return for 1954 claimed that amount as a tax deduction. The insurance company, each year since 1954, has reported as interest income to itself that portion of the prepaid interest which was earned by it during the year. Insofar as the participants in the transaction were concerned: (a) petitioner (the borrower) paid interest on a loan he obtained to pay for an annuity policy he wanted to buy and retain; and (b) the insurance company (the lender) annually accrued interest income to itself as petitioner's loan remained outstanding and his policy was not surrendered.

The Delaware State Tax Board ruled that the very interest involved here was properly deductible for Delaware State income tax purposes. It held that the above-described transaction had resulted in a genuine indebtedness upon which deductible interest had been validly paid.[3] The Tax Court of the United States disagreed with the Delaware State Tax Board. The Tax Court's decision was based solely on the similarity of the mechanics and form involved in the purchases of the annuities in this case and in the case of *Knetsch v. United States*, 364 U. S. 361 (1960). Unlike

[3] The Delaware State Tax Board found petitioner's purchase of his annuity, his loans and the interest paid on the loans in 1954 were all genuine transactions. It said: "The State argues, however, that there was no loan; that in effect, the taxpayer borrowed from the insurance company on the security of a promise made by the insurance company to pay a sum certain at a later date. Thus, so the argument goes, the taxpayer is paying 'interest' for merely an exchange of promises to pay. This argument ignores the economic situation of this taxpayer. The taxpayer has pointed out a source from which the loan could, and possibly may, in the future be paid. That source is, of course, the series of trusts of which he is beneficiary. The taxpayer has also pointed out the economic advantage of obtaining the annuity as early as possible. We do not pass on the case where a taxpayer has no expectancy and no reasonable hope of liquidating the loan made. We are saying merely that on the facts before us in this case we believe it was a true loan and that the interest paid thereon is deductible."

the Delaware State Tax Board, the Tax Court said nothing about the differences in substance between this case and the *Knetsch* case. The Court of Appeals of the Third Circuit agreed with the Tax Court's approach and affirmed its decision.

REASONS FOR GRANTING THE WRIT.

I. The decision of the court below is contrary to the decision of this Court in Knetsch v. United States and contrary to the numerous decisions of this Court and the various Courts of Appeals that substance, not form, governs the tax effect of transactions.

In *Knetsch v. United States*, 364 U. S. 361, 366 (1960), this Court said that "there may well be single-premium annuity arrangements with nontax substance which create an 'indebtedness' " and, therefore, valid interest deductions under Section 163(a) of the 1954 Code. This Court held that the facts of the *Knetsch* case showed it to be not such a case but, rather, showed that the transaction there involved was "a sham". Since that decision the Tax Court has, without exception, disallowed deductions in all reported cases, like the present one, where interest has been paid on loans made against annuities: see 2 C. C. H. 1963 Stand. Fed. Tax Rep. ¶1416.2756-2757; 2 P-H 1963 Fed. Taxes ¶13,006. It has reached those decisions, as it did here, simply because the evidence shows that the borrowings against an annuity policy represented the full loan value of the policy and a high-tax-bracket taxpayer had relied upon the representations of the Treasury Department that interest paid on such a loan would be deductible. On finding those facts in the present case the Tax Court said, in its one-page opinion:

"On the facts presented, the instant case is indistinguishable in principle from *Knetsch v. United States*, 364 U. S. 361, and is controlled by the Supreme Court's decision in that case". It is respectfully submitted that such a superficial treatment of this serious and far-reaching problem denies petitioner his day in court and is not consistent with, but is in violation of, the decision of this Court in *Knetsch v. United States*, 364 U. S. 361 (1960). The decision of the court below is, further, inconsistent with the long line of cases starting with *Gregory v. Helvering*, 293 U. S. 465 (1935), all standing for the proposition that it is the substance, not the form, of a transaction which controls for determining its tax consequences.

Here, in summary, is what the undisputed facts show in this case. There was no insurance program in petitioner's estate plan in 1954. His need for some life insurance or annuity in 1954 was apparent. He was 34 years of age and had a wife and two children. His need for estate planning was equally obvious. He was then receiving substantial income from trusts but when his mother dies the principal will vest in him. He will then have at least the problems of maintaining his standard of living and making appropriate disposition, or arrangements for disposition, of the principal to his heirs and other beneficiaries.

Petitioner was ineligible for life insurance but an annuity policy was available to him. Unlike a straight life policy, however, the annuity called for a large, immediate premium payment. He did not have the cash to pay the premium but he was convinced, and correctly so, that some of the advantages to him of the purchase of an annuity would be lost if he delayed buying it. In order to buy what he wanted, namely the features offered by an annuity policy, he had to borrow money. In short, the price of obtaining the economy of a youthful purchase of the annuity was the payment of interest on the loan necessary to pay the pre-

mium. This is the same price a person pays in borrowing to buy a house or car.

Petitioner, therefore, with a life expectancy of 39.1 years (Reg. §1.72-9, Table 1) purchased the type of policy which was designed to solve real problems which existed for him. He purchased a policy in an amount which was appropriate for the problems to be solved. Under his policy, at age 69-2/3 petitioner will begin to receive $10,371.82 per month. He can maintain his standard of living and make appropriate estate plans for his wife, children and other beneficiaries. The face amount of the policy is $500,000 and the loans against it will be easily repayable by petitioner upon the vesting in him of existing trusts. He believed the transaction would prove to be an appropriate estate planning step for himself and his family. That this was and is his genuine belief is proved by the fact that he still has the policy. Petitioner acted in good faith in making an honest judgment decision; nothing he did can fairly be called a sham. The interest paid by him was the commercial cost to buy for him the economical and substantial advantages of getting the most for each premium dollar.

How do the facts in this case compare with those in the *Knetsch* case? In 1954, Knetsch, then age 60 and with a life expectancy of 18.2 years (Regs. §1.72-9, Table 1) purchased from an insurance broker ten single premium annuity bonds, each in the face amount of $400,000 and each providing for payment of a monthly annuity 30 years later, or when Knetsch would be 90 years of age. The purchase price was $4,004,000 and Knetsch paid $4,000 and gave notes for $4,000,000. Each year the cash surrender value of the annuity bonds increased and each year Knetsch borrowed up to the increased cash surrender value less $1,000 and paid a year's interest on the amount of the total loan then outstanding. He surrendered the policies in 1956. At no time had the cash value of the bonds been more than

$1,000 in excess of the money borrowed by Knetsch and had he held the bonds to maturity, he would, at age 90, have begun to receive an annuity of $43 per month. There was no suggestion that Knetsch wanted or needed the benefits of an annuity or that he had any prospect of being able to or ever wanting to pay off the loan of over $4,000,000. It was apparent that Knetsch was not motivated by the desire to purchase an annuity since an annuity of $43 per month at age 90 could have been purchased by him for less than the initial payment of $4,000 plus his annual loss in the transaction and, moreover, each year until he surrendered the bonds he consistently prevented the policies from assuming any utility as an annuity by annually borrowing that year's increment in the cash value of the policies. It is no wonder that this Court stated that "it is patent that there was nothing of substance to be realized by Knetsch from the transaction beyond a tax deduction."

In determining whether the petitioner in this case was, in substance, buying the estate planning benefits of an annuity as compared to whether he, like Knetsch, was, in substance, buying a tax deduction, the following undisputed evidence in this case, which evidence was not present or was contrary to the evidence in the *Knetsch* case, is particularly significant:

First, in the discussions between petitioner and the insurance salesman it was the latter who was trying to make a sale and it was the latter who, after considering the possible sale of straight life insurance, concluded that he could not obtain such a policy for petitioner, and, therefore, suggested the purchase of an annuity.

Second, the deductibility of interest paid on loans, the proceeds of which were used to pay the premium on the annuity, did not come up until after the insurance broker had convinced petitioner of the latter's need to purchase an annuity. The subject then under discussion was whether

petitioner's interests would be better served by waiting several years until his cash position justified the purchase of the policy from his own capital or by borrowing money to purchase the policy then and there with the prospect that the loan could be paid off out of capital at such time as it was available.

Third, the borrowing of funds was suggested by the insurance broker only for the purpose of permitting petitioner to purchase the annuity at the young age of 34 since that achieves the goal of getting the most for each premium dollar.[4] The discussion was related solely to the relative cost of buying the annuity early in life with borrowed funds rather than later in life with petitioner's own funds. The problem under discussion was not petitioner's over-all tax obligations in 1954 or any other year. The problem was whether to use the trust principal, when it vests, to repay a loan against an annuity already purchased, or to originate the purchase of an annuity after the trusts vested.

Fourth, petitioner did not buy an annuity in an amount which required a loan greater than he can easily repay after the vesting in him of capital from presently existing trusts.

Fifth, petitioner did not buy an annuity in an amount which was beyond those of his minimum estate planning needs.

Sixth, petitioner did not purchase an annuity the monthly payments from which he would normally have no right to believe he could hope to collect. Using standard mortality tables petitioner, in January, 1954, was entitled to foresee a life expectancy to almost 74 years of age and the monthly

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[4] Any insurance company standard rate table reveals the mathematical correctness of this proposition. The benefits of the particular policy in the present case, for example, cost $500,000 at age 35, the same benefits would have cost $579,594.48 if purchased at age 40, $671,750.00 at age 45, $778,840.58 at age 50, $902,889.70 at age 55 and $1,047,155.11 at age 60.

annuity payments would begin before he reached 70; in addition, using his 77 year old mother as a guide, petitioner could justifiably anticipate more than a normal life expectancy.

Seventh, when prepaying interest in 1954, petitioner did nothing more than prepay interest for the few years during which he could normally have anticipated the continuance of the trusts which will not terminate until the death of his mother. Since she is still living, further interest has been required, and paid, to keep the policy in existence.

Eighth, petitioner has done nothing further with the policy since 1954 except to pay additional annual interest on the loan. This is consistent with his original intent to preserve the annuity for its estate planning purposes and inconsistent with the suggestion that he wanted tax advantages rather than annuity advantages. Nor has the petitioner cancelled or surrendered the annuity even though the Commissioner of Internal Revenue disallowed the 1954 interest deduction on November 30, 1956. Under the policy's loan provisions, petitioner could have surrendered the annuity at any time and been refunded all prepaid interest as of the date of surrender. Had petitioner not wanted the benefits of the annuity policy, had he been seeking only a tax deduction, he could and would have surrendered the policy on November 30, 1956, received back the unearned prepaid interest and given up the benefits and advantages of the annuity policy he owned. This he did not do. Even after the disallowance of the interest deduction became a matter of litigation and even after the risk of increasing interest on the tax assessment became a burden, petitioner did not divest himself of the annuity to minimize its possible financial cost. He preserved the benefits of ownership of the annuity and paid the tax assessment, with interest to February, 1961. His conduct again revealed an intent completely consistent with his conviction that the annuity is

a valuable estate planning asset. As such a tool, its purchase was a valuable commercial transaction for him.

This Court has stated that a genuine rather than a sham transaction can exist in a situation where a taxpayer obtains a loan to pay the premium on an annuity policy and thereafter deducts as interest the amounts which he pays as interest on such a loan. The Commissioner of Internal Revenue, by his numerous letter rulings, seven of which are in evidence in the present case, has also made it clear that in his opinion there can be valid as well as sham transactions in such circumstances. The petitioner and the insurance company in the present case have at all times both treated the interest payments made by petitioner to the company as being legitimate interest payments on an existing indebtedness. All of the testimony and all of the exhibits in the present case reveal the petitioner's action to be in substance what it is in form: a valid indebtedness upon which interest has been paid for the commercially reasonable and economically appropriate purchase of an annuity. The Tax Court's decision, as affirmed by the Court of Appeals for the Third Circuit, that the interest is not deductible is contrary to the evidence in this case and to the opinion of this Court in *Knetsch v. United States* that "There may well be single-premium annuity arrangements with nontax substance which create an 'indebtedness' for the purposes of §23(b) of the 1939 Code and §163(a) of the 1954 Code." It is also inconsistent with the numerous decisions which hold that substance, not form, control the tax consequences of a transaction.

II. The conclusion of the court below was based, in part, upon a two step line of reasoning which both parties agree was erroneous—the parties do not agree which step was in error but whichever one it is, it creates a conflict with a long line of well-established tax law—and, in part, upon a failure to apply to this case the scope of appellate review required by both Congress and this Court.

Whereas the Tax Court followed its pattern of mechanically denying any interest deduction to any high-bracket taxpayer whose interest payment arose out of a loan to pay the premium on an annuity, the Court of Appeals for the Third Circuit expressed two reasons for affirming the Tax Court. Both of the asserted reasons are incorrect and inconsistent with numerous decisions of this and other courts.

The first of the two reasons for affirmance appear in paragraphs 9 and 10 of the opinion of the Court of Appeals. After that opinion had been filed, the Commissioner of Internal Revenue filed a motion requesting that the court below revise its opinion by deleting those two paragraphs. Those paragraphs say, in summary: (1) the money passing from an insurance company to its policyholder against the security of a policy is an advance not a loan; (2) a loan creates an indebtedness but an advance does not create an indebtedness, therefore (3) the money passing from the policyholder to his insurance company for the use of the money advanced from the company to the policyholder cannot be interest on an indebtedness.

An eleven-page memorandum of law accompanied the Commissioner's motion arguing that the first of the two steps in the Court's reasoning was wrong. Respondent said, inter alia:

"1. The Court's statement first points out that the terms of the policy which permit borrowing against the cash surrender value do not create a personal liability from the policyholder to the company. With this we agree. The opinion then goes on to state that the 'advance did not create an enforceable liability,' thus equating the existence of personal liability with that of an enforceable liability. With this we disagree. It is well settled that recourse to the personal assets of a debtor is *not* necessary to the existence of a valid and enforceable debt. See e.g., Restatement of Security, Sec. 1, comment b. Indeed, one of the most common forms of a debt, the real estate mortgage, originated as a non-recourse debt completely free of personal liability on the part of the borrower. See 1 Glenn on Mortgages, Sec. 2, 5.4 (1943). This is precisely the case with the policy loans.

"2. We respectfully draw the Court's attention to the fact that its statement that policy loans, apart from those involved in transactions lacking commercial substance, do not give rise to indebtedness supporting the payment of interest is contrary to the view of Congress, and the courts."

In support of this proposition the Commissioner cited section 264(a)(2) of the 1954 Code, its legislative history and the legislative history of the Life Insurance Company Tax Act for 1955, C. 83, 70 Stat. 36. He also cited *United States v. Kentucky Home Mutual Life Ins. Co.*, 292 F. 2d 39 (6th Cir. 1961), *cert. denied*, 369 U. S. 803 (1962); *Diggs v. Commissioner*, 281 F. 2d 326 (2d Cir. 1960); *Keith v. Commissioner*, 139 F. 2d 596 (2nd Cir. 1944); *Meadows v. Continental Assur. Co.*, 89 F. 2d 256 (5th Cir. 1937), *cert. denied*, 302 U. S. 704 (1937); *Colston v. Burnet*, 59 F. 2d 867 (D. C. 1932); *Dean v. Commissioner*, 35 T. C. 1083 (1961); *Hooks v. Commissioner*, 22 T. C. 502 (1954); *Fox v. Commissioner*,

43 B. T. A. 487 (1939). He further referred several times to KREUGER & WAGGONER, THE LIFE INSURANCE POLICY CONTRACT, p. 180, 181, 185 (1953).

The Commissioner concluded his presentation demonstrating five reasons, practical as well as legal, why the opinion of the court below was incorrect saying:

> "5. The Court's statement runs counter to the fact that interest received on policy loans is taxed as interest income to the insurer. Sec. 804(b) (1) (A); *Kentucky Home Mutual Life Ins. Co. v. United States, supra;* see also *Standard Life Ins. Co. v. United States,* decided March 26, 1962 (S. D. Ind.) (9 A. F. T. R. 2d 1256). The term 'interest' in Section 804 has the same meaning as that term in Sections 61(4) and 163 (*General American Life Ins. Co. v. Commissioner,* 25 T. C. 1265) ergo, an indebtedness must arise from a policy loan."

Petitioners' answer to the Commissioner's motion to revise the opinion of the court below pointed out that the court below was wrong, but not for the reason advanced by the Commissioner. Petitioners pointed out that the court below was correct in stating that a payment by an insurance company to its policyholder, even though in the form of a loan against a policy, is, in substance, an advance payment of the policy proceeds. This proposition is supported by not only *Orleans Parish v. N. Y. Life Insurance Co.,* 216 U. S. 517 (1910) and *Williams v. Union Central Co.,* 291 U. S. 170, 179 (1934), cited by the court below, but also by *Schwartz v. Seldon,* 153 F. 2d 334 (2d Cir. 1945); *First National Bank of Wichita Falls v. State Life Insurance Co.,* 80 F. 2d 499 (5th Cir. 1935); *Gustin v. Sun Life Assur. Co. of Canada,* 152 F. 2d 447 (6th Cir. 1945); *In re Hirsch,* 4 F. Supp. 708 (S. D. N. Y. 1933); *Lee v. Equitable Life Assur. Soc. of U. S.,* 56 F. Supp. 362 (E. D. Mo. 1944). Petitioners described

the error of the court below as being in the second step of its reasoning. The correct characterization of the money passing from the insurance company to its policyholder as a prepayment or advance rather than as a loan does not mean that the policyholder's payment to the insurance company for the use of the money is not interest. Interest can be paid on an "advance". "Interest paid on indebtedness" means "compensation for the use or forbearance of money" (as correctly pointed out by the court below) and the petitioner was paying "interest" because, although entitled *eventually* to the proceeds of the policy, he was not entitled to the *immediate* use of the proceeds. His obligation for payment of interest arises from the forbearance of the insurance company to use the collected premiums to earn money.[4] The calculation of the premium to be paid by the policyholder was made upon the assumption that the insurance company would have the continued use of the premium with which to earn money. When the insurance company was deprived of its right to the present use of the premium by making an advance to its policyholder, the latter thus became obligated to pay "interest" on an "indebtedness"; i.e., the forbearance by the insurance company of its right to use the premium until the death of the policyholder. As was said by this Court in the *Orleans Parish* case, 216 U. S. at pp. 521-522:

> "A policy-holder desiring to keep his policy on foot and yet to profit by the reserve value that it has acquired, may be allowed at the plaintiff's [insurance company's] discretion to receive a sum not exceeding that present value, on the terms that on the settlement of any claim under the policy the sum so received shall be deducted with interest, *(the interest representing what it is estimated that the sum would have earned if retained by the plaintiff)*; and that on failure to pay any premium or the above-mentioned interest the sum re-

ceived shall be deducted from the reserve value at once." (Emphasis added.)[5]

The court below thereafter issued an order in which it slightly modified one of the two paragraphs of its opinion which the respondent had sought to have deleted. In the quotation below, the words added by the modification are capitalized and the words deleted from the original opinion are in brackets:

> "The cited section of the code provides that there shall be allowed as a deduction all *interest paid* . . . within the taxable year on *indebtedness*.' (Emphasis added.) The term 'interest on indebtedness' means compensation for the use or forbearance of money.' *Deputy v. du Pont*, 308 U. S. 488, 498 (1940). The prepayments made by the petitioner do not meet this accepted definition. The petitioner had a right, under the 'Loan Provisions' of the annuity contract, to 'borrow' an amount equal to the cash surrender value of the policy without incurring any personal liability for the repayment of the loan.
>
> "The transactions, although in the form of loans and treated as such by the Insurance Company, were in substance advance payments AGAINST RESERVES [of policy proceeds] for which the Company obtained a proportionate discharge of its obligations under the contract. *Orleans Parish v. N. Y. Life Ins. Co.*, 216 U. S. 517 (1910); *Williams v. Union Central Co.*, 291 U. S. 170, 179 (1934). These advances, UNDER THE FACTS AND CIRCUMSTANCES HEREINABOVE

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[5] See also **William Venning Couchman**, 30 B. T. A. 118 (1934), where taxpayer was permitted to deduct as interest the amounts he paid on a borrowing which was nothing more than an advance by the life tenant to the taxpayer against the latter's remainder interest in a trust.

SUMMARIZED, did not create [an enforceable liability, an indispensable element of an] 'indebtedness' within the meaning of the statute. WELLER V. C. I. R., SUPRA [*First National Company v. C. I. R.*, 289 F. 2d 861, 865 (6th Cir. 1961); *Autenreith v. Commissioner of Internal Revenue*, 115 F. 2d 856, 858 (3rd Cir. 1940); *Commissioner of Internal Revenue v. Park*, 113 F. 2d 352, 354 (3rd Cir. 1940)]. Absent such an indebtedness, the transactions lacked the commercial substance essential to a deduction under the statute."

The substitution of the *Weller* and *Emmons* citation (those two cases were decided together) for three other citations does not resolve the problems raised by the parties in this case. Quite to the contrary. In *W. Stuart Emmons*, 31 T. C. 26 (1958), for example, which also involved the deductibility of interest on loans to purchase a single premium annuity, the Commissioner contended that no indebtedness arose because the loan was given on the security of the policy and was without personal recourse against the taxpayers. In rejecting this contention, the Tax Court stated: ". . . Respondent's position here seems to require a holding that no interest deduction is permissible on any such loans. We have always been of the opinion that such interest, where paid by a cash basis taxpayer, is deductible. Cf. Estate of Pat E. Hooks, 22 T. C. 502."[6]

The Court of Appeals for the Third Circuit did not challenge the Tax Court's analysis when it affirmed in the *Weller-Emmons* cases, 270 F. 2d 294 (3d Cir. 1959), *cert.*

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[6] **Est. of Pat E. Hooks**, 22 T. C. 502 (1954), **acq.** 1955-1 Cum. Bull. 5, held that unpaid interest of a cash basis taxpayer which is added to the principal of a loan is deductible either by the decedent in his last income tax return or by the beneficiary under section 691(b)(1) where the proceeds of the policy, less the loan and interest due on the loan, are paid to the beneficiary upon the insured's death.

denied, 364 U. S. 908 (1960). It said it agreed with the Tax Court because "the entire transaction lacks substance" (p. 296) in the light of the practice of the taxpayer there to annually borrow the annual increase in loan value. It added, at p. 297:

> "If one ignores the practice of concurrently borrowing the increased cash or loan value of the contracts built up by prepayments of interest one might find some economic sense in the transactions, other than the hoped for tax deductions."

Nor did the minor phraseology changes in the order modifying the opinion resolve the problems. The court below is still saying: (1) that the loan made by the insurance company to its policyholder, although in the form of a loan, was in substance an advance payment of the policy and not a loan, and (2) since there was an advance rather than a loan there was no "indebtedness" and (3) since there was no indebtedness there could not have been "interest paid . . . on indebtedness" under Section 163(a) of the 1954 Internal Revenue Code. The Commissioner's motion had suggested that he does not agree with step (1) in the reasoning to conclusion (3). Petitioners' answer had stated that they do not agree with step (2) in the reasoning to conclusion (3). The problems described by the parties in this case are far from solved even in the modified opinion and problems which did not exist in the tax law before have now been created by the opinion of the court below.

The Court of Appeals for the Third Circuit in the present case also suggested that it was affirming the Tax Court under a test of appellate review which it described as follows:

> "We are required to consider the evidence in its entirety, bearing in mind the function of the Tax Court

> and the limited scope of appellate review. 26 U. S. C. §7482(c)(1). It is the function of the Tax Court to weigh the evidence, draw the inferences of which the evidence is reasonably susceptible, and, if necessary, resolve conflicting inferences."

An application of the correct measure of appellate review would not have resulted in an affirmance of the Tax Court in the present case. The limited scope of appellate consideration given by the court below was the no-longer-valid test of the *Dobson*[1] case. That, however, has not been the appropriate measure of appellate review of Tax Court decisions since the 1948 Amendment to the 1939 Code, §1141(a), 26 U. S. C. §1141(a) [now section 7482 of the 1954 Code]. That amendment provides:

> "The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code, *in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury . . .*" (Italicized phrase added in 1948.)

Under the tests laid down by Congress, the court below could not properly exhaust its duty of review by finding a rational basis for the conclusions of the Tax Court or that

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[1] **Dobson v. Commissioner**, 320 U. S. 489, 501 (1943):

> "It is difficult to lay down rules as to what should or should not be reviewed in tax cases except in terms so general that their effectiveness in a particular case will depend largely upon the attitude with which the case is approached. However, all that we have said of the finality of administrative determination in other fields is applicable to determinations of the Tax Court. Its decision, of course, must have 'warrant in the record' and a reasonable basis in the law. But 'the judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body.'"

the Tax Court's decision has "warrant in the record" and a reasonable basis in the law. The court below was required, by Congressional mandate, to review the entire record under a test that compels the conclusion that a finding is clearly erroneous "when, although there is evidence to support it, the reviewing court on the entire evidence is left with a definite and firm conviction that a mistake has been committed." *U. S. v. Gypsum Co.*, 333 U. S. 364, 395 (1948). There was no evidence at all to support the finding of the Tax Court in this case and no inferences can be drawn from the absence of such evidence except that all of the evidence to the contrary is true. When approaching the present case with an "attitude"* which incorporates the measure of appellate review supplied by the Congress in 1948 the first step is the recognition, as the court below did recognize, "There is clearly little or no dispute as to the facts." The next step, however, was misdirected by the court below. It said that the petitioner's arguments were predicated on "inferences consistent with his position" but contrary to the "inferences drawn by the Tax Court". However, the purposes of the petitioner in the transaction were not left to speculation or to inference. They were completely and unequivocally described by the petitioner. They were confirmed by the broker who sold him the annuity. They were in no way contradicted. The witnesses were in no way equivocal. There was never any finding that this undisputed and uncontradicted evidence was unreliable in any way or that any inferences unfavorable to the petitioner were even possible. The Tax Court simply found (1) that in the year he bought the annuity the petitioner's policy was sufficiently encumbered by loans that it could not provide any further benefits

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* As this Court has pointed out, the effectiveness of the rule as to the scope of review depends, "largely upon the attitude with which the case is approached." **Dobson v. Commissioner**, 320 U. S. 489, 501 (1943).

and (2) petitioner's tax bracket was sufficiently high that, for that year, the interest deduction provided a tax reduction greater than petitioner's out-of-pocket costs. But these facts, common to the present case and to the *Knetsch* case, do not provide the answer to either. This Court found the entire transaction in the *Knetsch* case to be a "sham". It stated that there may well be genuine transactions similar in form but dissimilar in substance. Mr. Knetsch entered into a "sham" transaction. That resolved Mr. Knetsch's case. It does not solve petitioner's case. Why did petitioner, not why did Mr. Knetsch, enter into this transaction, must be answered in this case on the evidence in this case.[9] That was the duty which the Tax Court in the present case failed to assume. This Court and Congress have imposed upon the circuit courts the duty to appraise each case on its facts to determine whether the courts below them performed this duty. In fact, that was the duty seen, accepted and followed by the Court of Appeals for Fifth Circuit in *United States v. Salley*, 290 F. 2d 708 (5th Cir. 1961), when it held that each case, including one which involves a high tax bracket taxpayer and interest paid on an advance or loan against an annuity, must be decided on the basis of

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[9] See **Affiliated Government Employees' Distributing Co. v. Commissioner**, 9th Cir. 9/16/63 63-2 U. S. T. C. ¶9707 (C. C. H.), affirming 37 T. C. 909 (1962), where the Commissioner successfully urged that motive is important in determining substance and the Court said:

> "Petitioner contends that motive or intent of the purchaser has no relevance to the determination whether 'stock' has been purchased. If no question were raised as to the substance of the interests or rights which allegedly qualified the members as 'stockholders,' we would be inclined to agree with petitioner. **Here, however, we feel that the issue is whether the members received any interest of substance in the corporation other than the privilege to buy at discount. In resolving this issue, we feel that the Tax Court was justified in considering all of the circumstances surrounding the purchase of memberships, including the motives or purposes of the parties to the transaction.**" (Emphasis added.)

whether or not the particular taxpayer's transaction was or was not "a sham". It was this duty which the Court of Appeals for the Third Circuit failed to assume, with the result that neither it nor the Tax Court has seen fit to decide petitioner's case on the facts and merits of his case.

III. The present case involves the issue of a discriminatory, retroactive reversal of widely known Treasury Department policy; this problem has not yet been resolved by this Court in the context of the reversal of tax rulings on the deductibility of interest paid on loans against annuities; this question should be answered by this Court since it is a problem common to many pending cases and the decision of the court below in the present case is inconsistent with the decisions of this Court involving other tax rulings.[10]

In *Knetsch v. United States*, 364 U. S. 361, 370 (1960), this Court said:

> Some point is made in an *amicus curiae* brief of the fact that Knetsch in entering into these annuity agreements relied on individual ruling letters issued by the Commissioner to other taxpayers. This argument has never been advanced by petitioners in this case. Accordingly, we have no reason to pass upon it."

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[10] This Court is presently being asked to consider the related question of whether the Commissioner must allow the deduction of at least the out-of-pocket expenditures incurred by a taxpayer in reliance upon the Commissioner's long series of rulings: Petition for Writ of Certiorari in **Gerstell, et ux. v. Commissioner**, U. S. Sup. Ct., October Term, 1963, No. 482. That problem has arisen in the **Gerstell** case because that petitioner has sold his annuity and his transaction is closed.

The present case squarely raises this issue and this issue is a problem common to a considerable number of pending lawsuits.

In reply to requests for rulings submitted by, or on behalf of, individuals contemplating a program of borrowing in connection with the purchase of annuity contracts, the Commissioner issued a great number of formal letter rulings categorically stating that interest paid on loans similar to those here involved was deductible. Seven of those rulings were shown to petitioner in this case when he was deciding whether to buy an annuity policy on borrowed money or wait until he could buy it with his own funds after the vesting in him of several substantial trusts. Those rulings bore dates from October 16, 1947 to August 31, 1953. They thus reflected a consistent position of the Commissioner spanning a period of six years. During those years, there was wide circulation of copies of such rulings and the tax features of the plans ruled upon by the Commissioner were widely publicized. They were readily available to the insurance broker who produced copies and showed them to petitioner in December, 1953 or January, 1954.

In fact, it was not until March of 1954 that the Internal Revenue Service published in the Internal Revenue Bulletin a contrary ruling with respect to this type of case. *Rev. Rul.* 54-94 1954-1 Cum. Bull. 53. However, even on that date, the ruling made no statement as to its effective date.

In March, 1954, the Internal Revenue Code of 1954 was in the process of enactment. Congress was fully aware of the interest deduction problem created by plans similar to that involved in the Commissioner's long series of rulings. H. R. Rep. No. 1337, 83d Cong., 2d Sess. 31 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 38 (1954).

When it enacted Section 264(a)(2) of the 1954 Code Congress provided that:

"(a) General Rule.—No deduction shall be allowed for——

"(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

"Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954."

This enactment is both unusual and significant. Congress, in enacting the law which would reverse the long standing rulings of the Treasury Department, did not say that no deduction should be allowed for any interest of this type *paid* after March 1, 1954. In recognition of the existence of the well-publicized favorable position of the Commissioner upon which many taxpayers had relied in the purchase of annuities, Congress elected to deny an interest deduction only in the case of contracts *purchased* after March 1, 1954. Interest *paid after* March 1, 1954 on loans against annuities *purchased before* March 1, 1954, was still deductible.

Congress thus specifically revealed its recognition of the unfairness of prejudicing any person who had, in the past, acted in reliance upon the well-known position of the Treasury Department.[11]

Notwithstanding the clear language of section 264(a)(2) and unambiguous statements in the committee reports, high ranking Internal Revenue Service officials later stated to a

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[11] Even the Commissioner of Internal Revenue has recognized the risk of inequity in retroactive revocation or modification of rulings and has established a general policy of making such revocations or modifications of published rulings prospective only. Treasury Reg. §601.201(1)(5) and (9).

Ways and Means subcommittee that the March, 1954 ruling would not be applied retroactively to taxpayers who had letter rulings addressed to them, at least to the extent that those taxpayers had relied on the letter rulings to their detriment. Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, Progress Report, April 22, 1957, pp. 191-192. The pendency of this and similar cases shows, however, that at least as to those taxpayers who did not receive letter rulings with their names on them, the Commissioner has proceeded to give fully retroactive effect to his changed position. This, despite the fact that these taxpayers had read and relied upon the very same official rulings which the Commissioner regards as protecting the taxpayers whose names appear on them and despite the fact that the number of rulings clearly evidenced an established administrative position upon which the taxpayers were justified in relying.

In *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U. S. 110 (1939) and *Provost v. United States*, 269 U. S. 443, 458 (1926), this Court established the principle that the Treasury Department may not retroactively change a prior official construction of an internal revenue statute which has survived reenactment of such statute. The rationale underlying this principle is that by reenacting the law without material change, Congress has recognized the administrative construction and has indicated an intention to continue that construction in force. The same reasoning is equally applicable to the present problem where the law, when changed for future transactions, was preserved for past ones.

In addition, in *Automobile Club v. Commissioner*, 353 U. S. 180 (1957), this Court approved a retroactive reversal of a ruling to a particular automobile club where it was shown that all automobile clubs were being treated in the same manner pursuant to a previously-published ruling of general application. This Court made it clear, however, that

the Commissioner's action did not have inequitable results and indicated that a retroactive action which did have inequitable results would be disapproved.

In the present case the inequity of affording no protection to the petitioner is twofold. First, the Commissioner is denying the interest deduction for interest paid prior to his published change in position. The application of the March, 1954 ruling to interest paid by petitioner before that date is particularly inequitable in this case since petitioner would probably have postponed the transaction had he not been reassured by rulings which were favorable to other taxpayers. Secondly, the Commissioner is applying the new ruling retroactively only to those taxpayers who did not obtain their own private rulings. Those taxpayers who had their names on the rulings shown to petitioner (one was his cousin and one was the broker through whom petitioner's policy was issued) will not have the rulings reversed retroactively to their detriment.

It must be emphasized that this is not a situation in which one taxpayer, after the event, hears about and seeks the protection of another taxpayer's private ruling. Rather, it is a situation in which, prior to the event, petitioner knew of and acted in reliance upon a well-established position of the Commissioner evidenced by his numerous formal written rulings. He should not be penalized for failing to take the meaningless step of obtaining a letter addressed to him and repeating what had already been said clearly to many other taxpayers! As was said by Justice Frankfurter in his concurring opinion in *United States v. Kaiser*, 363 U. S. 299, 308 (1960): "The Commissioner cannot tax one and not tax another without some rational basis for the difference."[12]

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[12] The same proposition was expressed by Justice Black in his dissenting opinion in **St. Regis Paper Co. v. United States**, 368 U. S. 208, 229 (1961).

The Court of Appeals for the Third Circuit said in the *Weller* and *Emmons* cases, 270 F. 2d 294 (3d Cir. 1959), *cert. denied*, 364 U. S. 908 (1960), which it refused to reconsider in the present case, that there was no discrimination since all taxpayers *without rulings* are being treated equally. This is the equivalent of saying that there is no discrimination against a particular race if all members of that race are treated in the same manner—unfair as the treatment may be. Such reasoning runs counter to what this Court has consistently required in the administration of our laws —whether federal or state—since *Yick Wo v. Hopkins*, 118 U. S. 356, 373-374 (1886).

In the circumstances of the present and similar cases, the discrimination against taxpayers based merely on their failure to obtain rulings with their names typed on them, when such rulings were common knowledge and were available for the asking, is improper and contrary to the clear and unambiguous language of section 264(a)(2). It is contrary to the legislative history of that section as well. It is also contrary to the elementary concepts of fairness in the functioning of executive departments of the government and to the most fundamental concepts of Anglo-Saxon jurisprudence. This Court should not allow the Commissioner of Internal Revenue to apply his 1954 ruling retroactively to any taxpayer who acted in reliance upon the integrity of the Commissioner's long-standing and well-known administrative policy. Certainly he should not be

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"Our Government should not, by picayunish haggling over the scope of its promise, permit one of its arms to do that which, by any fair construction, the Government has given its word that no arm will do. It is no less good morals and good law that the Government should turn square corners in dealing with the people than that the people should turn square corners in dealing with their Government."

See also Justice Douglas' concurring opinion in **Comm'r v. Lester**, 366 U. S. 299, 306 (1960).

permitted to apply his changed position with respect to some taxpayers and not as to others.

CONCLUSION.

For the foregoing reasons, this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX A.

ON PETITION FOR REVIEW OF DECISION OF THE TAX COURT OF THE UNITED STATES.

Argued March 21, 1963.
Before HASTIE, GANEY and SMITH, *Circuit Judges*.

OPINION OF THE COURT.

(Filed August 29, 1963.)

By SMITH, *Circuit Judge*.

The petitioner William K. Carpenter, joined by his wife Frances K. Carpenter,[1] challenges as erroneous the Tax Court's decision that interest prepayments on loans made against an annuity policy were not deductible from gross income under 163(a) of the Internal Revenue Code of 1954, 26 U. S. C. 1954 ed. 163(a). The decision of the Supreme Court in *Knetsch v. United States*, 364 U. S. 361 (1960), and that of this Court in *Weller v. C. I. R.*, 270 F. 2d 294 (1959), cert. den. 364 U. S. 908 (1960), are dispositive of the contentions raised by the petitioners.[2] However,

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[1] This petitioner is joined because she was party to a joint return.

[2] See also **Diggs v. C. I. E.**, 281 F. 2d 326 (2nd Cir. 1960), cert. den. 364 U. S. 326; **Pierce v. C. I. E.**, 311 F. 2d 894 (9th Cir. 1962).

it is argued that the present case is distinguishable on its facts from those cited. We disagree.

The matter came before the Tax Court on stipulations of fact, exhibits annexed thereto, and the testimony of the petitioner and one other witness. The relevant and material facts, as to which there is no dispute except as to the inferences drawn therefrom, are set out in the carefully detailed memorandum of the Tax Court (62,176 P-H TAX CT. MEM.). We herein summarize only those facts which we deem essential to an adequate understanding of the questions raised.

The petitioner purchased from the Old Republic Life Insurance Company an annuity policy which provided for monthly payments to him slightly in excess of $10,000, the said payments to commence when he reached seventy years of age. At the time of the purchase, in January of 1954, the petitioner was not yet thirty-five years of age and had a life expectancy of approximately thirty-nine years. He was a man of considerable wealth and the recipient of substantial yearly income from a series of trusts,[3] the corpora of which would become distributable upon the death of his mother, who was then seventy years of age. Aside from other payments made by the petitioner, with which we are not here concerned, the single premium in the amount of $500,000 was paid as follows: $8,000 from the personal funds of the petitioner, and $492,000 from the proceeds of a loan in the said amount advanced by the Philadelphia National Bank under circumstances hereinafter described.

Pursuant to prearrangement, the petitioner deposited with the Bank his personal check in the amount of $8,000, payable to the Insurance Company, and contemporaneously therewith applied to the Bank for a loan in the amount of

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[3] The trust income was in excess of $649,000 per year.

$492,000. The loan was granted and the proceeds thereof, together with the proceeds of the check, were credited to the account of the Insurance Company. This loan was evidenced by a personal note and was secured by a pledge of the annuity policy. Thereupon the petitioner made application to the Insurance Company for a loan in an amount equal to the full loan value of the policy, and contemporaneously therewith deposited with the Bank his personal check in the sum of $19,680, payable to the Insurance Company and representing the prepayment of interest on the anticipated loan for the first year.

The latter application was granted, and at the direction of the petitioner the proceeds of the loan were paid directly to the Bank in repayment of its loan. The loan from the Insurance Company was evidenced by the usual annuity loan agreement, under the terms of which the petitioner agreed to repay the loan, together with interest thereon at the rate of 4% per annum. The agreement provided that there was no personal liability on the petitioner for the repayment of the loan and that the sole recourse of the Insurance Company was against the annuity contract which was pledged as collateral. The details of the transactions, outlined in the Tax Court's memorandum, are of no relevance here. The loan was never repaid.

The transactions hereinabove outlined were consummated on January 25, 1954, six days after the annuity policy had issued. Thereafter, on November 17, 1954, the petitioner prepaid to the Insurance Company seven years' interest in the amount of $170,154.33, thereby increasing the loan value of the policy to $605,000, the value it would have attained in its eighth year. At the same time the petitioner borrowed an additional sum of $113,000, which was equal to the full amount of the increment. This loan, like the earlier one, was not repaid and the ostensible indebtedness of the petitioner was equal to the full loan value of the annuity policy.

The petitioner, joined by his wife, filed an income tax return for the year 1954, therein claiming a deduction in the amount of $189,834.33, representing the full amount of the interest paid on the purported indebtedness to the Insurance Company. The deduction was disallowed by the Commissioner and the disallowance resulted in the assessment of a tax deficiency in the amount of $168,952.57. The assessment and the interest thereon were paid, and the proceeding before the Tax Court followed.

The Tax Court found that the loan transactions lacked commercial substance of economic benefit to the petitioner apart from the intended tax advantage. This finding of fact, upon which the ultimate decision of the Court rested, is herein challenged as clearly erroneous. The question for determination is whether the transactions in question, entered into in the taxable year of 1954, created an indebtedness within the meaning of 163(a) of the Internal Revenue Code, supra. The answer is clearly in the negative. *Knetsch v. United States*, and *Welle[illegible] C. I. R.*, both supra.

The cited section of the code provides that there "shall be allowed as a deduction all INTEREST PAID . . . within the taxable year on INDEBTEDNESS." (Emphasis added). The term "'interest on indebtedness' means compensation for the use or forbearance of money." *Deputy v. du Pont*, 308 U. S. 488, 498 (1940). The prepayments made by the petitioner do not meet this accepted definition. The petitioner had a right, under the "Loan Provisions" of the annuity contract, to "borrow" an amount equal to the cash surrender value of the policy without incurring any personal liability for the repayment of the loan.

The transactions, although in the form of loans and treated as such by the Insurance Company, were in substance advance payments of policy proceeds for which the Company obtained a proportionate discharge of its obliga-

tions under the contract. *Orleans Parish v. N. Y. Life Ins. Co.*, 216 U. S. 517 (1910); *Williams v. Union Central Co.*, 291 U. S. 170, 179 (1934). These advances did not create an enforceable liability, an indispensable element of an "indebtedness" within the meaning of the statute. *First National Company v. C. I. R.*, 289 F. 2d 861, 865 (6th Cir. 1961); *Autenreith v. Commissioner of Internal Revenue*, 115 F. 2d 856, 858 (3rd Cir. 1940); *Commissioner of Internal Revenue v. Park*, 113 F. 2d 352, 354 (3rd Cir. 1940). Absent such an indebtedness, the transactions lacked the commercial substance essential to a deduction under the statute.

It seems obvious that apart from the tax advantage the overall transaction was of no economic value to the petitioner. He paid to the Insurance Company a total of $689,834.33, representing premium and interest, and immediately withdrew $605,000, the full cash surrender value of the policy. The Company retained $84,834.33, the surplus. The petitioner received in return an annuity contract, the economic benefits of which were immediately exhausted by the advances. He purchased nothing more than a potential tax deduction having a cash value of $168,952.57, an amount equal to the deficiency assessment. The net gain to the taxpayer, if the claimed deduction had been allowed, would have been $84,118.44. The only economic benefit derived from the transaction was the possible tax reduction.

There is clearly little or no dispute as to the facts. The several arguments advanced by the petitioner are predicated on inferences consistent with his position but contrary to the clearly permissible inferences drawn by the Tax Court. The answer to these arguments is a simple one. We are required to consider the evidence in its entirety, bearing in mind the function of the Tax Court and the limited scope of appellate review, 26 U. S. C. §7482(c)(1). It is the function of the Tax Court to weigh the evidence,

draw the inferences of which the evidence is reasonably susceptible, and, if necessary, resolve conflicting inferences. *Boehm v. Commissioner*, 326 U. S. 287, 293 (1945); *Comm'r v. Scottish American Co.*, 323 U. S. 119, 123, 124 (1944); *Helvering v. Nat. Grocery Co.*, 304 U S. 282 (1938). The decision of the Tax Court, based upon its findings of fact, is conclusive unless it appears from an examination of the record that the findings of fact were clearly erroneous. *Kisting v. C. I. R.*, 298 F. 2d 264, 269 (8th Cir. 1962); *Commissioner of Internal Revenue v. Thompson*, 222 F. 2d 893, 895 (3rd Cir. 1955); *Ansley v. Commissioner of Internal Revenue*, 217 F. 2d 252, 256 (3rd Cir. 1954). If the inferences drawn by the Tax Court are supported by substantial evidence, it is immaterial that different inferences might fairly be drawn from the same evidence. Ibid.

The petitioner contends that the disallowance of the deduction was arbitrary, capricious and discriminatory, and therefore should be nullified by this Court. The contention rests on evidence that the purchase of the annuity contract and the ensuing loan transactions were induced by the representations of the insurance broker, supported by rulings issued to taxpayers other than the petitioner, that interest payments on policy loans would be deductible. The question raised was heretofore considered by this Court and decided adversely to the petitioner's contention. *Weller v. C. I. R.*, supra. The invitation of the petitioner to reconsider the question must be rejected.

The decision of the Tax Court will be affirmed.

A true copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

On Motion to Revise the Opinion heretofore filed

Present: HASTIE, GANEY and SMITH, *Circuit Judges*.

ORDER.

(Filed October 11, 1963.)

This matter having come before the Court on the motion of the respondent to revise the opinion filed on August 29, 1963; and, the briefs of the respective parties having been considered:

IT IS ORDERED that paragraph 10 (9),* appearing on pages 4 and 5 of the opinion, be deleted; and,

IT IS FURTHER ORDERED that the following paragraph be substituted:

> "The transactions, although in the form of loans and treated as such by the Insurance Company, were in substance advance payments against reserves for which the Company obtained a proportionate discharge of its obligations under the contract. *Orleans Parish v. N. Y. Life Ins. Co.*, 216 U. S. 517 (1910); *Williams v. Union Central Co.*, 291 U. S. 170, 179 (1934). These advances, under the facts and circumstances hereinabove summarized, did not create an 'indebtedness' within the meaning of the statute. *Weller v. C. I. R.*,

* The numeral "9" appeared in the order dated October 11, 1963. The numeral was changed to "10" on October 21, 1963.

supra. Absent such an indebtedness, the transactions lacked the commercial substance essential to a deduction under the statute."

For the Court:

WILLIAM F. SMITH,
Circuit Judge.

APPENDIX B.

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES.

Present: HASTIE, GANEY and SMITH, *Circuit Judges*.

JUDGMENT.

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

Attest:

IDA O. CRESKOFF,
Clerk.

August 29, 1963.

In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 635

WILLIAM K. CARPENTER and FRANCIS K. CARPENTER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In January 1954, the petitioner purchased for $500,000 a single-premium annuity contract from the Old Republic Life Insurance Company. The cash surrender or loan value of the policy was $492,000 and would increase at approximately 3% a year. Upon acquiring the policy, the petitioner immediately "borrowed" from the Company its full cash value, $492,000. The loan bore interest at 4% per year and was secured solely by the policy, the petitioner having no personal liability for its repayment. The proceeds of the loan were used to repay a one-day bank loan by which the purchase of the policy had been financed.

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Also in 1954, the petitioner prepaid eight years' "interest" on the loan in the amount of $189,834. As a result of the interest prepayment, the cash surrender value of the policy increased by $113,000 (*i.e.*, to the value it would have had at the end of eight years). Upon payment of the interest, the petitioner again immediately "borrowed" back the full increase in the cash surrender value, $113,000. The net result of the year's transactions was that petitioner was out of pocket $84,834 (having paid the Company $689,834 and received back $605,000) and owned an annuity contract with a net value of zero.

In his income tax return for 1954, petitioner claimed a deduction for interest paid in the amount of $189,834. The Commissioner disallowed the deduction and as a result determined a deficiency of $168,952. The Tax Court upheld the deficiency, and the court of appeals affirmed.

1. This case is indistinguishable from and is fully controlled by *Knetsch* v. *United States*, 364 U.S. 361. Here, as there, the transaction resulted in the creation merely of offsetting paper promises and was wholly lacking in commercial substance. In effect, the Company promised to pay petitioner $492,000 plus accretions at the rate of 3% in exchange for petitioner's promise to pay the Company $492,000 plus interest at the rate of 4%. With the amount of the loans and the value of the policy being kept equal, the purported "obligations" could at any time be canceled out against each other, with neither party having any further liabilities. For its role in creating the facade, the Company retained $8,000 of the initial payment

and the 1% differential in the "interest" rates. For petitioner, however, the transaction was economically self-defeating: "there was nothing of substance to be realized * * * from this transaction beyond a tax deduction" (*Knetsch, supra*, at 366). As the Court held of the substantially identical transaction in *Knetsch*, a transaction so lacking in commercial substance is a "sham" for federal tax purposes and does not create an "indebtedness" the "interest" on which is deductible under § 163(a) of the Code. And since, under *Knetsch*, it is "what was done" and not motivation as such that is controlling (*id.* at 365, n. 2), petitioner's contention (Pet. 10–16) that he had valid non-tax reasons for entering the transaction would be irrelevant even if it were plausible.[1]

The decision below is also fully in accord with the lower court decisions. With the single exception of the conflicting decision which provided the occasion

[1] Petitioner asserts that he had decided to invest an expected inheritance in such a policy but did not wish to postpone the purchase until he received the inheritance because the policy would cost more if purchased later (Pet. 6, 11, 13–14). With the cash surrender value of such a policy increasing at a rate of 3% a year, it is of course not surprising that the initial cost of purchasing an equivalent policy would increase from year to year at about the same rate (compare petitioner's examples of what the premium would have been had the purchase been postponed (Pet. 14, n. 4) with the table of cash surrender values in the policy (R. 173a)). What petitioner does not explain, however, is the non-tax reason for paying 4% interest to obtain the benefit of the 3% rate of increase in the value of the policy. The necessary result of adding the interest payments to the initial premium is that the total cost to petitioner was *greater*, not less, than if the purchase of the policy had been delayed.

for the grant of certiorari in the *Knetsch* case (*United States* v. *Bond*, 258 F. 2d 577 (C.A. 5)), the lower courts have uniformly denied effect, for purposes of generating an interest deduction, to the type of transaction involved here. See, *e.g.*, *Weller* v. *Commissioner* 270 F. 2d 294 (C.A. 3), certiorari denied, 364 U.S. 908; *Diggs* v. *Commissioner*, 281 F. 2d 326 (C.A. 2), certiorari denied, 364 U.S. 908; *Pierce* v. *Commissioner*, 311 F. 2d 894 (C.A. 9), certiorari denied, 373 U.S. 912; *Salley* v. *Commissioner*, 319 F. 2d 847 (C.A. 5).

2. Since the decision below is fully supportable on the authority of the *Knetsch* case and of the court of appeals' own prior decision in the *Weller* case, *supra*—the primary basis for the decision—petitioner's argument (Pet. 17–23) addressed to a further and unnecessary observation made in the court's opinion and later modified [2] is beside the point and affords no basis for review of the decision by this Court.

3. Petitioner's reliance on private ruling letters addressed to other taxpayers (Pet. 27–33) is unavailing, for it is settled that such rulings, addressed to individual taxpayers, have no binding effect as to other

[2] At one point in its opinion, the court commented that policy loans are, in substance, advance payments of policy proceeds (Pet. 37–38). Because that statement appeared to constitute possible prejudgment of another case which had been argued before the Third Circuit *en banc* but had not yet been decided (*United States* v. *Wilson, et al.*, Nos. 13858, 13859, 13957, 14091 and 14092), the Commissioner moved for a modification of the opinion. Objection was made to the court's opinion only insofar as it purported to go beyond the facts of this case (see Pet. 17–18). On October 11, 1963, the court amended its opinion to limit its characterization to the circumstances of this case (Pet. 40–41).

taxpayers,[3] regardless of whether they have actually relied upon them.[4] And any suggestion that the private rulings, even if not binding in themselves, reflected a consistent administrative practice which should control the interpretation of the statute (see Pet. 29–30) is foreclosed by this Court's contrary interpretation of the statute in *Knetsch*.

The petition for certiorari should be denied.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.
JOHN B. JONES, JR.,
Acting Assistant Attorney General.
GILBERT E. ANDREWS,
CAROLYN R. JUST,
Attorneys.

JANUARY 1964.

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[3] *E.g., Automobile Club* v. *Commissioner*, 353 U.S. 180; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265–266, n. 5; *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 467–468; see Treasury Regulations on Procedural Rules (1954 Code), § 601.201(l) (4), (5), and (7); cf. 1954 Code § 7805(b).

[4] *Gerstell* v. *Commissioner*, 319 F. 2d 131 (C.A. 3), certiorari denied, December 9, 1963 (No. 482); *Weller* v. *Commissioner*, 270 F. 2d 294 (C.A. 3), certiorari denied, 364 U.S. 908; *Goodstein* v. *Commissioner*, 267 F. 2d 127 (C.A. 1).

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